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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

NIC #8863-82
2 November 1982

National Intelligence Council

MEMORANDUM FOR: Director of Central Intelligence

FROM: Maurice C. Ernst
NIO for Economics

SUBJECT: Items in the Shultz Package

1. In your 29 October memo you asked me to draft a memorandum for you to send to the President on the relative value of the items in the Shultz package. Attached is a recent, but probably not the latest version of Secretary Shultz' "non-paper." It reflects a good deal of negotiating with the Europeans, but retains the essential elements of the original memo.

2. Potentially the most important part of the package by far is the commitment of our Allies to seek a common approach to economic relations with the USSR which takes into consideration the security interests of the Alliance. If some institutional mechanisms can be established to follow up on this broad commitment, its long-term impact on Western economic relations with the USSR could be substantial. Although our Allies view their trade with the USSR in a far more positive light than we do, they may become more inhibited about undertaking large new joint projects, such as the Siberia-to-Western Europe gas pipeline currently under construction. Since the Soviets will depend primarily on large new joint projects to increase their foreign exchange earnings in the 1980s and beyond, they stand to lose billions of dollars over a period of years. Our Allies view this broad commitment as a two-way street, which constrains our freedom of action as well as theirs.

3. An agreement on institutional mechanisms for consultation and coordination on Allied economic relations with the USSR is extremely important. The Allies want to use the OECD as much as possible for this purpose, and there is no doubt that this organization has the best analytic capability. But NATO is the logical institution to examine East-West economic issues in the context of Alliance security, and serious policy coordination among the major Allies will require regular meetings in a much smaller group.

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4. Among the more specific areas of agreement, the one likely to yield the largest tangible benefits is the tightening of COCOM. The European governments in the past year or so have become more receptive to US initiatives to expand the number of products and technologies under COCOM control and to improve enforcement of these controls. The Shultz agreement could give this trend an additional boost. Even the French agree in principle that exports of militarily important goods and technology should be stopped, although they, like the others, generally put the burden of proof on the United States. Tighter COCOM restrictions will make the modernization of Soviet weapon systems slower or more costly. To the extent that Soviet military modernization is impeded, the US and its Allies could save billions of dollars in defense expenditures without weakening our relative military posture.

5. An agreement to try to eliminate Western government assistance to trade with the USSR--especially in the form of subsidized credits--may be worth very little or a good deal, depending on how it is implemented. Elimination of interest subsidies alone would cost the USSR less than \$200 million a year and, since the French are the source of most of these subsidies, the chances of our gaining their cooperation are slim. If, however, an agreement should lead to reducing the use of government-guaranteed credits, a practice followed by all the countries, the impact on the USSR could be substantial. Sales of equipment for most large projects are normally covered by government-guaranteed credits. Government guarantees are a form of political risk insurance, without which Moscow could obtain little, if any, long-term credit.

6. An agreement to study European energy requirements in the next decade and beyond is worth very little by itself. Indeed, such a study has already been launched under the auspices of the International Energy Agency. Studies will show that Western Europe will need large additional supplies of imported gas in the 1990s and beyond. Although West European demand for gas will probably not be sufficient to justify building a new Soviet gas pipeline for several years, there is a potential longer-term demand for one or two such pipelines, Soviet earnings from which could exceed \$10 billion per year. If alternative sources of energy are to be found, planning for their development will have to begin during the next few years. Norwegian gas is the best alternative, but it will be more expensive than Soviet gas. This higher cost could be considered a legitimate premium to pay for greater Alliance security, but some mechanisms would have to be developed to finance this premium, by subsidizing either the Norwegians or their customers.

7. A study of the strategic implications of exports of Western advanced technology and equipment, including oil and gas equipment, to the USSR and Eastern Europe, is unlikely to lead to any significant new restrictions on such exports. Although denial of a wide variety of Western

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oil and gas equipment would cost the USSR billions of dollars, the Europeans almost certainly would accept such controls only for items which can be shown to have important military uses, and under a COCOM framework.

A handwritten signature in dark ink, appearing to read "M. C. Ernst", with a long horizontal line extending to the right.

Maurice C. Ernst

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